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PROPOSED RULE X-15C1-10

Submitted to the

Securities and Exchange Commission

by the

BOARD OF GOVERNORS

National Association of Securities Dealers, Inc.

OCTOBER 20, 1942

(Transmittal letter, dated October 20, 1942, addressed to Mr. Ganson Purcell, Chairman, Securities and Exchange Commission, should be read in conjunction with this memorandum)

IN OUR opinion this proposed Rule is unworkable and impracticable but it is not our purpose to discuss technical and mechanical details in this memorandum. Nor, for the purpose of this memorandum, do we intend to examine its legal authority in the light of the intent of Congress and the provisions of the statute. We take issue with the proposal on more fundamental grounds and deny that there is any necessity for such a rule.

We take that position not because of any sentimental urge to defend the securities business against renewed public indictment of its treatment of investors. We take that position as a result of practical experience and out of a knowledge of conditions as they truly exist.

The Commission has been regularly informed of our actions but it would seem

appropriate to review again the nature and extent of them as they bear upon the subject of this proposed Rule.

This Association was a little more than a year old when, in April, 1941, it undertook an intensive program of examination of all members and aggressive enforcement of its Rules of Fair Practice.

This program was instituted for two reasons: in the first place, it was believed that such a program was necessary in order to ascertain the nature of the Association's problems; in the second place, it was believed at the time that such a program was necessary to carry out the concept of an industry attempting, with governmental cooperation, to put and to keep its house in order. The word "attempt" is used advisedly. At that time "self-regulation" was only an attempt; today we believe the concept of self-regula-

tion originally held by the Congress, the business and the Commission has justified itself.

In a period of seventeen months well over 2,500 members of the Association have been examined at least once in respect to financial condition and business practices. The Association's staff has employed several means in conducting these examinations.

The Association's staff has personally examined over 500 member firms. In addition, approximately 300 member firms have been examined by Certified Public Accountants trained in respect to brokerage accounting and brokerage practices. Since it was our desire to complete this job of examining the entire membership before the end of the last fiscal year on September 30, 1942, it was decided to examine the remaining members of the Association by questionnaire. The questionnaire employed consisted of two parts, the first covering financial conditions; the second dealing with business practices in general, including questions which would disclose whether the member broker-dealer understood and properly disclosed to his customer the capacity in which he was acting; whether the member understood and complied with governmental rules and regulations concerning the keeping of books and records, the hypothecation of customers' securities, etc.; and whether the member was complying with the Rules of Fair Practice of the Association. The final phase of this second part of the questionnaire included disclosures in respect to sales and profit policies.

The question of fair profit policies and the sale of securities at prices not reasonably related to the market for such securities has been but one phase of the business practices which the Association has carefully examined.

What have been the results of this examination program? In the first place, the Association, acting through its District Business Conduct Committees, has taken disciplinary action against firms in those instances in which their sales and profit policies appeared to be inconsistent with good business ethics. This action has taken several forms. Business Conduct Committees have expelled members from membership in the Association. They

have suspended members according as the facts and circumstances warranted. In many instances, members have been fined. District Business Conduct Committees have on occasions been able to effect substantial restitution to customers. In addition to the foregoing, the Association, through its Business Conduct Committees, has, as a result of the examination and study of these reports of examinations and questionnaires, directed letters to firms cautioning them and further advising them concerning the mandates of the Rules of Fair Practice and urging them at all times to consider first and foremost their customers' welfare and secondly the question of their own profits.

Thus, this phase of the Association's work has taken three forms—first, appropriate disciplinary action; second, restitution where feasible and possible; and third, the continued efforts to promote a universal awareness of the responsibility of brokers and dealers to deal fairly with their customers.

The Association, through its Business Conduct Committees, is engaged in advancing the theory that a profit in this business must be based on service. This has been the established policy of this Association in order properly to inculcate within the membership and the industry that professional spirit which the great majority of the industry wishes to promote.

From a statistical standpoint, the results of the Association's examination program are as follows: It has been found necessary to take disciplinary action against approximately 5% of the membership of the Association; in all, 170 complaints have been filed since January 1, 1941. Of these, 99 involved violations of our Rule which provides that members shall deal fairly with their customers in the purchase and sale of securities. Thus, as a result of a concerted, well-organized effort on the part of the Association to root out such bad practices within the membership as do exist, the Association has found it necessary to file complaints against approximately 2.6% of its membership where the matters concerned involved allegations of dealing unfairly with customers in the purchase and sale of securities, which, of

course, includes the matter of dealers' buying or selling securities at prices not reasonably related to the market.

Our knowledge of the practical nature of this matter does not end with this report of what our program has disclosed to be the size of the problem and the steps taken to solve it. The Association has prepared a detailed analysis of profit policies of practically all members. It knows the number and the location of members whose policies are in need of policing. Their number is small in relation to the total of our membership but the important fact is that we know who they are and where they are and we have already demonstrated our capacity to deal with them. We are not winking at abuses and we do not deny that a minority in the business perpetrate them, but we repeat: we know who they are and where they are.

We are not wholly satisfied with our examining processes, effective as they have been to date. As the Commission has been notified previously, examination of each member at least once a year is our program for the future. We have developed a plan to improve upon investigations into members' business practices which will bring to light information upon which the Association can move promptly against all types of improper acts and practices.

We are, as always, prepared to discuss these matters in detail with the Commission.

Representatives of the staff of the Commission have stated this proposed Rule to be the result of an increasing awareness of a practice growing in the over-the-counter market for dealers to buy from or sell to their customers at prices bearing no reasonable relationship to the market. It has further been said by representatives of the staff that this practice has been indulged in by many over-the-counter brokers and dealers. These statements of purpose, in our opinion, constitute an indictment and cast a reflection on the entire industry, which we do not believe to be either true or warranted by the facts. It has been the Association's experience that there is a group in the industry which engages in practices not consistent with good business ethics. The Association and the

membership are presently and have been in the past engaged in a sincere endeavor to eradicate and to eliminate from the industry the practices of this group, not only in the interest of the public, but also in the selfish interest of the business itself. The previous statement of the examination work of the Association substantiates the opinion that only a small group in the business has been transgressing the bounds of good business ethics in respect to their sales and profit policies in the business transactions.

The staff of the Commission has further stated that this alleged practice which motivated this proposed Rule is a growing practice and that the Rule is to protect investors who are frequently charged prices for securities which bear no reasonable relationship to the existing markets. We submit that the Association cannot but conclude, because of our own experience and information in their field, that the record does not bear out these contentions and statements of the Commission's staff that the alleged practice is either a *practice within* the industry, that it is an *increasing practice*, or that investors are *frequently* charged prices bearing no reasonable relationship to the market. We further submit that those few who are in the marginal element of the industry constitute a small and diminishing minority; that this proposed Rule may very well harm the present trend of investigation and examination work within the industry being done by the Association and the Commission; and completely disorganize the work which is presently being done to promote high standards of business and commercial ethics within this business. Authorities who have had experience in this field fortify us in our opinion that rules such as this proposal are not self-enforcing and, in and of themselves, will not eradicate bad ethical practices. These authorities further say that no rule is as effective as correction and enforcement through examination work.

The Executive Committee, in the foregoing statement, has attempted to demonstrate that the objectives of the Association and the Commission can best be attained by a continuation of the cooperative work by the Association and the Commission in an en-

deavor to advance and enforce high standards of commercial honor and integrity, just and equitable principles of trade, and business ethics. We are of the certain opinion that the Association can demonstrate to the Commission, to the industry, and to the public that the public interest, the interest of the Commission, and the selfish interest of the industry at large can better be served by this coöperative effort than by a rule which, in our considered opinion, is unnecessary and which will take from the Commission as well as the Association many of the tools so effectively used to date.

The members of the staff of the Commission do *not* claim that the membership of this Association has *not* been adequately policed, nor that the problem the staff is endeavoring to solve is one which is a prevalent practice within the membership of the Association. It has been suggested that this Association is the proper vehicle for the solution of such problem as does exist. The staff of the Commission, in answer to this suggestion, has stated that there is a primary objection to this suggested solution, inas-

much as there are a great many registered brokers and dealers who are not members of the Association and who are undoubtedly guilty of the practice of over-pricing and who would be able to operate without supervision comparable to that of the Association during any period of experimentation with this suggested solution.

The Association has made a spot check of the list of registered brokers and dealers who are not members of this Association and who are not members of Stock Exchanges to determine whether, in fact, these non-members registered with the Commission are actually engaged in the securities or investment banking business. Our inquiries disclose that a very large proportion of these non-members actually are not engaged in the securities business. We have ascertained that many of those registered with the Commission are registered only incidentally to other activities and are not, in fact, engaged in the securities business; many still registered are now deceased; many have left the business for innumerable reasons and have merely neglected to withdraw their registrations.

In conclusion, the position of the Executive Committee in this statement is as follows:

(1) Association experience has demonstrated that only a small marginal element within the business has engaged in the practices which the proposed Rule would seek to cure;

(2) the purposes of the Association and the Commission can best be served in the interests of all concerned by further coöperative effort;

(3) the Association will demonstrate that the problem can be met most effectively in the interest of the public and the business by continuing our coöperative work in an atmosphere of mutual confidence;

(4) to put such a rule into effect would undoubtedly harm a large portion of the business and not reach those at whom the proposed Rule is directed, it being our considered opinion that the proposed Rule, if promulgated, would be easy to evade;

(5) the number of registered brokers and dealers outside of the Association is not large enough nor is their volume of business important enough to justify such a rule on the grounds that they are beyond N.A.S.D. policing and therefore constitute a major problem for the Commission; and

(6) there would be no further need for the Association in the field of work in which it has been most active and successful.